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NOTE: The phone has been ringing and there's anxiety in the air–so I decided to get this Letter out a few days early. I hope this mailing clears up some questions–and lowers the anxiety level a notch or two (anyone who isn't anxious here must be missing the news).

THE PICTURE: My feeling for many months has been that subscribers should be in a position that can be described by the single word–LIQUID. The question on my mind has been, what would constitute liquidity, and how do we get there. I finally decided that the best formula I could come up with for liquidity was 25%-30% in gold coins (or bullion) and 70% to 75% in US 91-day Treasury bills. In the face of many objections and questions, I insisted that the gold be held outright. I was against margins, I was against gold futures, I was against gold shares. As for the other part of the equasion, I insisted that we hold our dollars **outside** the banking system, and that means short-term T-bills. It does not mean bank accounts, it does not mean C/D's, it does not mean commercial paper, it does not mean savings & loan accounts or savings accounts.

Interest rates are now spiraling higher, and from here on it makes no difference whether the Fed is chasing the money market up or whether the money market is being squeezed by the Fed. The operative fact is that interest rates are climbing–in many instances (i.e., the discount rates, Treasury bond yields) to new record highs.

In my opinion, what we're seeing on the money front at this time is a big bear market rally in the dollar. The daily chart of the leading "hard" currencies (mark, yen, franc) shows patterns that fairly scream "top out," and those currencies have been collapsing against the dollar. The stock market has been going down against the dollar, bonds have been sliding against the dollar, gold, silver, platinum and many commodities have been heading down against the dollar. All of which points to one thing–for a while, maybe months, maybe two or three months or longer (at least while interest rates are churning upwards) the dollar is going to be KING.

Here is what I think could be coming up in the period ahead. My guess (based on the crashing action of the NYSE breadth indices) is that the US could be moving into recession within 3 to 6 months. Recessionary signs could, in fact, appear by year-end. If it looks like a severe recession, then we can be sure that there will be a whopping drop in corporate (and personal) tax receipts to the Government. In that case (with Government spending holding steady or rising) economists will be adding up the potential size of the 1979-80 Federal deficit. The size of that deficit (given a recession) could be awesome. The Fed will have to print money to cover that deficit. On top of that, we could expect interest rates to come down as the Fed changed its stance from fighting inflation to fighting recession. Under those circumstances, the bear market rally in the dollar would top out, and the dollar would be plunging down as rapidly as it is now climbing.

In the face of a sliding dollar and massive new US deficits, I would expect gold to go into the third phase of its bull market. In fact, I would expect a worldwide move into gold to start at that time.

One thing I am fairly certain about–if we do go into a recession, the Government is going to find that it is extremely difficult (regardless of pump priming) to turn the economy around. First, it is a fact that it has taken an increasing amount of inflationary infusions to turn each recession (since 1949) around. But more important, the price structure of goods and materials (houses, cars, raw materials) has held pretty much together on every economic downturn since 1949. I believe that we are moving very close to a period where the price structures are going to buckle. If prices fall apart and the debt structure topples over, no amount of Fed monetization is going to turn the recession around. A situation like that would be the most frightening economic event to appear since the 1930's depression. I believe that we could see deflation again. I believe we could see a collapse of the debt structure and a net deflation.

STOCK MARKET: I want to show a long-term chart to give some overall perspective to this situation. I am therefore including this (page 2) chart of the Dow (monthly) covering the period of 1957 to the present. I last published this chart in Letter 731, at which time the 21-month moving average (MA) was holding just above the very long-term 156-month (13 year) MA. I just computed the end-of-October figures and they are plotted on the chart. The picture, in a word, is ominous.

If you study the chart, it is clear that the upside momentum of the 13-year MA is now in the process of rolling over. After climbing relentlessly higher during the 1950's, '60's and '70's, this very long term moving average of the Dow now is ready to descend. It seems to me that this action carries very bearish implications. It's almost as if we are seeing the end of an era. I've always had (and still have) the greatest respect for the D-J Industrial Average and the messages sent out by its price movements. And here we have action that has not been seen by anyone in this generation. What could the Dow be seeing?

Here's my guess, and it's the same guess and warning that I've been putting forth for the past two years. I think the Dow is telling us that the giant debt structure of the US, the debt structure (margins) in the stock market, the housing market, the banking system, the consumer installment system–is in danger of being "called."

Right now the banks are loaned up as tight as a drum. They are in a struggle to try to build up their liquidity. This means that interest rates will remain high, that the banks will pay "through the nose" for additional cash, and that loans are going to be increasingly difficult to get. In this situation, margin accounts of all kinds are going to be squeezed, and by margin accounts I mean the margin in everything including cars, houses, consumer installments, stocks, bonds, you name it.

This is the reason I have been insisting on **liquidity** for my subscribers. The name of the game for the next year is going to be liquidity. Liquidity is the scarcest commodity around today. Everyone and his maiden aunt has loans outstanding. Nobody is in a net cash position. And now those loan positions are going to be squeezed. Some will not be renewed. Some will not be financed. And the weaker ones, the ones around the ragged edges–are in danger of crumbling.

I've been warning about this debt situation for many months, and I'm not going to go into the whole thing again. But I just heard that consumer debt is up another $3.2 billion in October, and it will be most interesting to see the new figures on the NYSE margin debt (now $12.4 billion). But here is the point I want to make to my subscribers. I want us all to be in what is perhaps the greatest CONTRARY ECONOMIC STANCE of the past 30 years–the stance of being liquid and solvent in late-1978!

GOLD: I did a lot, and I mean a lot of thinking about the gold action of the past few weeks. One conclusion I came to is worth repeating. The beauty of gold is that it is pure money. No government issues it, nothing is owed against it, it has no liabilities. Gold does not have to be "managed" by any nation the way a paper currency does.

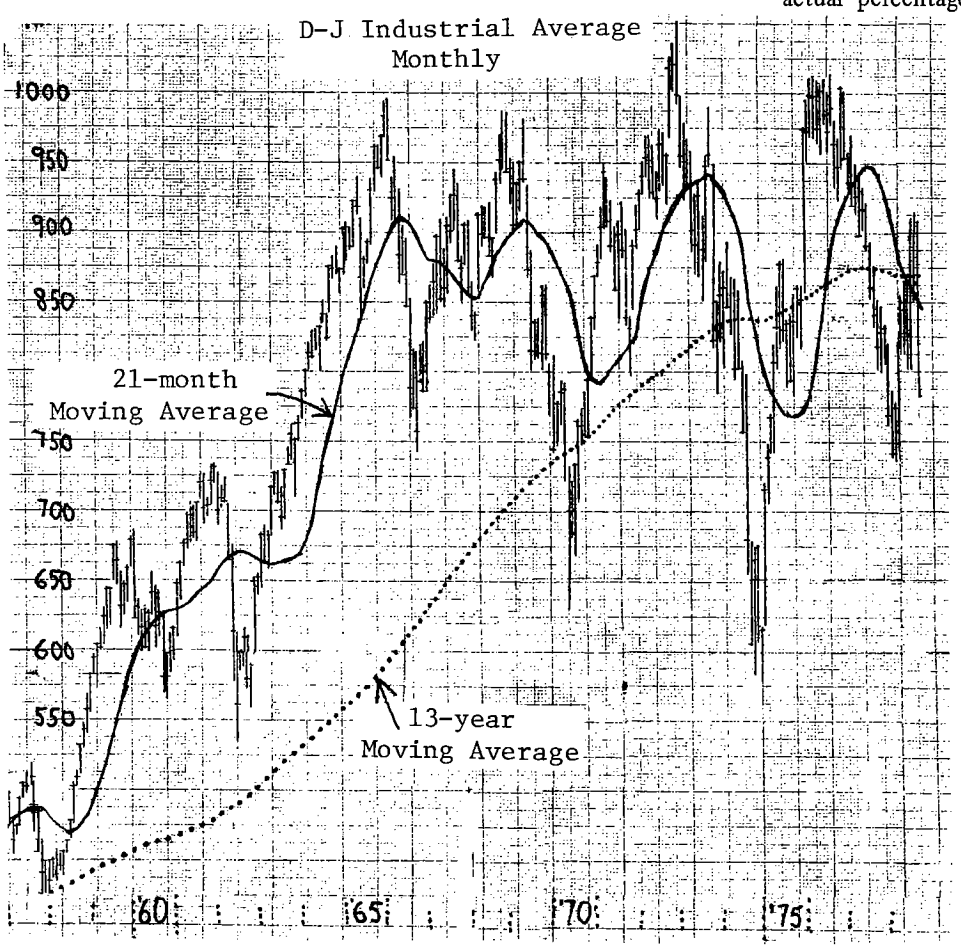
There is only one theoretical pressure on gold and that is the cost of carrying it. That cost can be measured by the return you might get somewhere else. For instance, right now you can get 9% on T-bills, so you forfeit 9% when you own gold. The higher interest rates go, the bigger the forfeit to the gold holder. So the gold holders are paying for the safety of real money over the danger (especially in times like these) of holding paper "money." In other words, the cost of the gold insurance today is about 9% a year.

However, there is a futures market in gold. The futures market is a thinly margined market, and against every gold future there is a debt. That debt is the margin. The futures market is the place where there is a debt against gold, and for this reason in an interest rate explosion (such as we had two weeks ago when the discount rate went to a record 9.5%) the gold futures were caught by surprise–and they panicked.

In my opinion, the Fed's discount rate move and the announcement of stepped up auctions in gold **aborted** the second phase of the gold bull market. I would say that we are now in the correction of the second phase–with the third phase of the gold bull market somewhere ahead. The correction following the second phase of a bull market can be deceptive and severe. I believe the gold correction should take the form of an A-B-C move down. I would think that the drop from 243 to 210 represents part or perhaps all of the first down-leg, the A-leg. Following the A-leg we should see a B-leg which should take gold some distance back towards its 243 peak. The recovery should be 1/3 to 2/3 which means we should see gold rise to around 220 or 230 on the first major rally. In some instances, a recovery will actually take the B-leg to new highs (as was the case in 1974), but then there is still the final C-leg which lies ahead.

CHANGE: I want to make a change at this point in our "liquidity" mix, and this means a change in percentages. I don't know how far this correction of the second phase of the gold bull market will go. It's possible the worst we'll see is a testing of the 200 level or it's possible that gold will go lower. I do NOT think the gold bull market ended a few weeks ago at 243, but I do think that there is a chance that gold will make a more extended correction–before going into its third phase.

Now I can't decide everything for everybody. Some people will insist on the protection of gold and will be willing to "ride through anything," because they don't want to sell their gold for "more dollars." Others with more ability and desire to **trade** may want to cut very low on their gold holdings (with the stipulation that they will buy back when we are convinced that the second phase correction is over). My advice to subscribers at this time is to cut back some of your gold holdings, but I can't make the actual percentage decision for you. If you just can't decide, I would say that 15% of assets in gold is about right. If you are a good and steely-nerved trader, you may want to step aside altogether and take a chance on being able to move back into gold at lower levels.



One more thing–please don't write or call and argue with me about my gold stance. Believe me, I agonize over every position I take, and I don't make changes lightly. I'll go into this in greater detail in the next Letter, slated to be mailed on November 22.

Question: Against your advice, I have half my assets in gold. I see now in this volatile market that I have more gold than I can sleep with. What do I do now?

Answer: No position in anything is worth losing sleep over. During the past six months I have had to caution many people against a disproportionately large position in gold. I told them that the dollar was not at zero yet, and that all markets of any kind will rally, and that nothing in this business is a sure thing. Thus my insistence on treating gold as *insurance*, rather than an exciting trading vehicle.

In answer to your question, I have found that the surest action in the market is the approximate 50% recovery follwoing a panic decline.

The decline in gold since the highs certainly possessed panic characteristics. Therefore, from a tactical standpoint I would think that the best place to lighten up would be at the halfway level between whatever lows are being established and the 243 peak of October 30. Thus, if for the sake of argument, 210 is the low for gold on this decline we should expect a recovery to "around 226." This general area would be the one I would suggest lightening up in.

Question: Russell, what do you think of the "hard" currencies here?

Answer: At least for the intermediate term, they have topped out. There's just no question of that in my mind. Therefore, I would want to hold NO francs, marks or yen at this time.

Question: Alright, I'm going to cut down on my gold position. What do I do with the dollars I receive?

Answer: Put them into Treasury bills, 91-day maturity, and roll those bills over (i.e., reinvest them as each 91-day period expires). The bills are the safest thing to have while the dollar is rallying and while deflationary forces (higher interest rates) are buffeting the money markets.

Question: Russell, what causes you to make a change in your investment position? How do you decide when to make a move?

Answer: I change on the basis of signals from my charts, my intuition, and my reasoning. But I must admit that reasoning plays a far smaller role than the first two.

NEW ORLEANS: In a word, this was by far the most interesting monetary conference I have ever participated in. The speakers were good, and the attendees were just as good. The people (2500 of them!) were mostly older, mostly highly intelligent, mostly trying to learn what is going on, and most very serious, very frightened. There was an air of expectancy and anxiety hanging over that crowd.

What I enjoyed most was the opportunity to spend a lot of time with some very interesting people, men like Ted Desloge, Jr., and Mike Helberg (commodity men), Milo Hamilton (brilliant Managing Editor of *Commodities Magazine),* R. E. McMasters (genius behind "The Reaper" commodity report), Bob Bleiberg, Editor of *Barron's*, "Poppa" Eliot Janeway, Harry Browne (one of the best speakers there, in Switzerland or anywhere else), Howard Ruff (whose hoards of subscribers will soon blanket the nation), Mark ("around the world") Tiers of Hong Kong, and dozens of friends not the least being Jim and Jackie Blanchard who were the brains and doers behind the whole affair.

What I got out of the conference was that almost no one is liquid. Everybody is carrying debt. It makes me wonder how long the ultimate debt liquidation can be held off. I think we're moving close to the big "call" on debt–very close. I also learned (and this surprised me) that there are two kinds of gold. There's gold in the vault ("I wouldn't touch that, brother, those are my survival chips") and the gold futures ("Oh, I love playing the futures"). I was amazed at how many people had both kinds of gold and how many people were in the futures market. At any rate, I want my subscribers (unless commodities are your specialty and you know exactly what you're doing) to be only in the bullion or gold coins. Futures entail debt and margins, and that means you can be forced to the wall.

THE LAW: A subscriber just sent me a little book about Walter Russell (no relation), the amazing painter, sculptor, musician, philosopher, who enjoyed cosmic consciousness. Russell talked about the law of the universe, and his tehsis was that you must give an equal amount *or more*–for what you receive. In other words, it's immoral to try to get more than you give, and in the end the only power immorality has is the power to destroy itself.

Russell's statement of the universal law made me think of our Government and inflation. And of course, inflation is the perfect evil, the perfect breaking of the universal law in that the inflators are always seeking to get more than they give. And that is why the inflation policy of the US is doomed, it will be destroyed as sure as night follows day. You can bank on it–with gold and Treasury bills.

LATE STOCK MARKET NOTES: As of November 7, I counted 19 out of 21 days down on the A-D ratio. That represents the worst breadth series I have seen in 25 years of watching markets. Thus, the odds would seem to be pointed strongly towards some kind of rally, holding action, upward bias, what have you. Now another thing I've learned is that when the market does not respond to extremes–something is seriously wrong. Thus, if the Averages break their preceding lows (Industrials 792.45, Transports 208.71) I would say that we have a market that is in the throes of the most insistent liquidation that I personally have ever seen. In other words, when the market doesn't respond to a technical extreme–watch out! There's something out there that you and I don't know about. And it doesn't pay to analyze it–it simply pays to "get the hell out of it's way!"

LATE GOLD NOTES: The first chart (page 4) shows a ratio-scaled weekly chart of gold. So far, the correction has held within the upward confines of the channel, and that's a big plus for gold. But if the full correction is extended and deeper, it is going to break below the lower channel lines. I always prefer to be very careful when any item breaks below its rising ratio trendline.

Obviously, I can't tell how this gold correction is going to work or how long it's going to take or how deep it's going to go. However, figure a gold break below 197 will serve to rupture the rising trendline. If that occurs, then I would not ignore the "cutting down on gold" which I disucssed in the paragraph entitled "Change."

The chart of gold and the gold stocks (GSA) is rather interesting. On the correction GSA broke cleanly below its August and September lows. But the bullion would not confirm (p. 4 chart). Bullion would have to break below 197.50 (the August low) in order to confirm. This non-confirmation is a technical element of strength in the bullion picture, and it also underscores the importance, the great importance of 197 as a support level for gold.

I would say that if the second phase correction of gold can run its whole length without ever violating 197.50, then gold would be stronger than even I suspect it is during this corrective phase. In other words, it will be a remarkable performance if the second phase correction of gold takes the metal no lower than 197.

Final question:What would it mean if gold pushed up and actually recorded a new high above 243? Would we still be in the corrective phase for gold?

Answer: I would still be a seller of gold above 243, and I think the only thing that could send gold to new highs at this time would be a news event such as the fall of Iran. Once a correction is underway, it goes to conclusion, and only the pattern of the correction is subject to variations.

NEXT MAILING: November 22